From: "Hoopes, Nat (Scott Brown)" [redacted]

Sent: Monday, March 14, 2011 4:16:09 PM

To: [redacted]

Cc:

Subject: contacts

Attachments:

Thanks again for breakfast meeting - was good to catch up.

Who would be the best 2-3 people to email on designation vs. Volcker Rule 3% thoughts.

Nat

From: "Hoopes, Nat (Scott Brown)" [redacted]

Sent: Friday, March 25, 2011 4:07:41 PM

To: [redacted]

Cc:

Subject: RE: Volcker 3% thoughts

Attachments:

Hahaha - I'm pathetic, I know.

-----Original Message-----
From: [redacted]
Sent: Friday, March 25, 2011 4:06 PM
To: [redacted] Hoopes, Nat (Scott Brown)
Subject: RE: Volcker 3% thoughts

You might think this is about the 3% limit, but this actually only reflects 3% of his thoughts on Volcker.

-----Original Message-----
From: Yi, Charles
Sent: Friday, March 25, 2011 4:03 PM
To: Hester, Barrett (Bret); 'Hoopes, Nat (Scott Brown)'
Subject: RE: Volcker 3% thoughts

But Nat didn't tell me he was going to send us his PhD thesis...

-----Original Message-----
From: Hester, Barrett (Bret)
Sent: Friday, March 25, 2011 4:02 PM
To: 'Hoopes, Nat (Scott Brown)'
Cc: Yi, Charles
Subject: RE: Volcker 3% thoughts

Thanks Nat. Charles said you warned him yesterday this was coming!

-----Original Message-----
From: Hoopes, Nat (Scott Brown) [redacted]
Sent: Friday, March 25, 2011 2:53 PM
To: Hester, Barrett (Bret)
Subject: Volcker 3% thoughts

Bret,

Here are my thoughts on bank asset management and the Volcker Rule, based on my engagement during Dodd Frank and the conversations I've had since with concerned parties - would appreciate if you could forward over to folks over at the Fed who are working on this - or let me know who I should email...it looks long but really isn't too bad!

The Volcker Rule and Bank Asset Management

The broad purpose of section (d)(1)(G) in Dodd Frank is to allow banking entities to continue to offer hedge funds and private equity funds to clients, but with much more regulation. Asset management firms currently offer their hedge funds and private equity funds to both existing clients of the banking entity and to new clients that have not previously invested in bank-affiliated PE/Hedge funds. They may be offered to potential investors that have not yet established a formal fiduciary or advisory relationship with the banking entity, as long as they are offered to those investors in compliance with SEC requirements. A bank-affiliated fund that performs very well, for instance, might be raising a new fund and catch the eye of a qualified investor - a pension fund or endowment or high net worth individual - that is not, and has not previously been, an investor or a client of the bank.

One of the conditions of (d)(1)(G) is that a fund be organized and offered only in connection with the provision of trust, fiduciary or investment advisory services and only to customers of those services. That language must be read in light of how the asset management business has traditionally been conducted. Banking entities are already subject to the SEC's requirement that they have a "substantive pre-existing relationship" ("SPR") with customers in order to satisfy the conditions for a private placement, and that standard should inform and be applied to (d)(1)(G)(ii). In fact, the FSOC Study endorsed that as one of the possible standards. SPR generally requires: awareness of financial experience and sophistication (an actual substantive relationship of a business nature), and a reasonable belief that the client is capable of evaluating the merits and risks of the proposed investment. Examples of SPRs include, but are not limited to: existing clients of the banking entity, clients that previously invested in a hedge fund or private equity fund sponsored by the banking entity, potential investors who were previously solicited for other products; potential qualified investors who are referred by another division of the banking entity, or an affiliate of the banking entity, where employees in that division or affiliate know the potential investor's current financial situation; totally new prospects do not have an SPR, but can develop one after an appropriate cooling off period.

The FSOC Study however, also proposed a possible alternative interpretation from certain banking regulations relating to identity theft, privacy regulations and certain consumer provisions that define customer as an individual or entity with an account or other existing relationship with a bank. Those definitions do not work when applied in a hedge fund or private equity fund asset management context. With my boss having worked very hard to preserve the bank affliated model during negotiations of Dodd Frank, my sense is that such a reading of the law would undermine the entire purpose of (d)(1)(G)'s preservation of the bank asset management businesses. It would mean that no new clients could be solicited for investment in any bank affiliated hedge fund or private equity fund. It would undermine the clear and long-standing SEC guidance on the tests that are used to ensure that private placements of those funds are offered properly and only to the appropriate potential investors. It would also mean that asset management businesses affiliated with banking entities would be materially disadvantaged compared to asset management firms that are not bank-affiliated. This would push yet more investment capital into far less-regulated corners of the financial services industry.

Firm/Manager Investment

Section (d)(l)(G)(vii) of the Volcker Rule provides that only directors or employees engaged directly in providing "investment advisory or other services to the hedge fund or private equity fund" are allowed to invest in a fund. The Volcker Rule recognized that investors expect employees to have "skin in the game" - a sentiment shared by market participants: ILPA Private Equity Principles emphasizes the importance of having the managers of a fund invest in their fund and Morningstar ratings for mutual funds place heavy emphasis on employee investing. I was always puzzled as to the purpose of asking employees of banking entities to invest in third party funds and to divest their holdings in the funds affiliated with the bank. The concern about a possible "bailout incentive" has been completely (and wisely) eliminated in the bill by the inclusion of (d)(1)(G)(v) and (viii) and by extending the Section 23A prohibitions applicable to the banks and their subsidiaries to bank holding company subsidiaries. Any "bailout" by a bank holding company of an affiliated fund is now illegal. More on that later.

The FSOC Study suggests that at least some agencies think it might make sense to include permitted employee/director investments in the 3% de minimis caps that apply to banking entities. I would suggest that the agencies clarify that "other services" be interpreted as broadly as possible to allow employees to

demonstrate "skin in the game" as is commonly sought by asset management clients and consultants and to reflect bank employees' desire to invest in funds. Why is this important? One example is a firm's investment/risk committee. Members of a banking entity's investment/risk committee are charged with reviewing possible fund investments. To make sure that they take this effort seriously in weighing risks and returns, they should be allowed and encouraged to have personal stakes in the funds. This 'skin in the game' helps ensure that investments are reviewed carefully by a senior team of firm leaders that actually have a stake in the performance of the fund. In my view, the term "or other services to the fund" therefore should be interpreted to include the reasonable provision of positions such as the administrative staff, oversight and risk analysis/management, legal, compliance, regulatory, fundraising/investor relationships, sales and marketing, tax, accounting, etc. - the other services that directly support the fund.

In my view, "Permitted Employee Investments" should not count toward the de minimis tests. The potential inclusion of director and employee investments for purposes of the 3% de minimis calculations is inconsistent with (d)(1)(G), which permits such investments by directors and employees directly engaged in providing investment advisory or other services to a fund organized and offered by the banking entity. That suggested approach potentially creates conflicts between the banking entity and its employees for the 'right' to invest in sponsored funds. Limiting the amount those employees can invest will also have the unwanted effect of removing the link between the employees' personal investments and the investments by clients in the funds. The natural check on employees' risk-taking and short-term profits will be diminished. Limiting investments by investment professional employees of banking entities would also provide an advantage to non-bank-affiliated funds. In my view, the plain language of section (d)(1)(G)(vii), and its distinct place outside the deminimis investment limits contained in sections (d)(1)(G)(iv) and (d)(1)(f), make it clear that those employees who satisfy the (d)(1)(G)(vii) test may invest without limit in the particular hedge fund or private equity fund.

"Super" 23A

In the words of my old boss at what is now Trilantic Capital Partners, "you can't lose more than all the money you've invested." That is also true with bank affiliated funds under the 23A restrictions: banking entities can invest up to 3% of tier one capital in funds that are affiliated and if all those funds were to fail and be liquidated, that 3% equity investment could indeed be entirely lost. But in part because of the Super 23A restrictions, there the damage ends. Section (f) of the Volcker Rule contains the so-called "Super" 23A provisions that prohibits "covered transactions" between a banking entity and any hedge fund or private equity fund that is advised, sponsored or organized and offered by the banking entity. As it was understood by all who worked on the language at the time, the purpose of this section was to prevent the possibility that a banking entity could put its health (and therefore the health of the financial system) at risk by "throwing good money after bad"- entering into a transaction to "bail out" a troubled affiliated fund in order to avoid the negative financial or public relations repercussions of an affiliated fund's failure.

The FSOC Study, however, strangely suggests that Super 23A could also apply to funds with which a banking entity has substantial relationships without specifying that they need to be an affiliate of the banking entity under the Bank Holding Company Act. There is no statutory basis for extending Super 23A in that way. The text is clear: it only applies to funds that are sponsored, advised, managed or organized and offered by a banking entity, or funds that are controlled by such funds (meaning effectively that the fund is a subsidiary of the fund). In fact, Senators Merkley and Levin introduced an amendment (S.A. 4101) that would have extended Super 23A in the manner the FSOC Study now suggests is still possible. That amendment was never granted a vote in the Senate. To now try to reconstitute that rejected concept would be to over-ride clear Congressional intent. Unlike possible bailouts of affiliated funds (which is addressed in the law), such a reading would also be a "solution in search of a problem."

Employee Pension Funds

No one seems to think that a banking entity's employee pension plan should fall under the definition of "banking entity" and therefore be caught by the Volcker Rule. Yet, until that is made clear by the agencies, the provision will continue to cause confusion among banking entities. The agencies should provide that section 2(g)(2) of the Bank Holding Company Act should not apply to investments made by employee pension funds for purposes of the Volcker Rule. Under section 2(g)(2) of the BHC Act, a

bank holding company's employee pension fund would effectively be treated as if it were a subsidiary of the bank holding company for purposes of the Volcker Rule - prohibiting it from making or retaining investments in a hedge fund or private equity fund without complying with the Volcker Rule.

Employee pension funds are highly regulated: Their trustees have extensive fiduciary duties under ERISA; they are required to invest pension assets in a manner that is in the best interest of the employees - if the best interest of the employees would be served by allocating a portion of the fund assets to investments in hedge funds or private equity funds, the trustees should be allowed to do so. Pension funds for the employees of both banking entities and non-banking entities currently invest a portion of their portfolio in hedge funds or private equity funds as a means of diversification, asset allocation and portfolio management. It is inconceivable that Congress intended for the Volcker Rule to interfere with such investment activities and to uniquely penalize employees of banking entities by doing so.

3% per fund - De Minimis as Snapshot
The 3% per fund limit should be calculated as a snapshot as of the end of the seeding period. This is common sense: if a hedge fund loses value or investors withdraw capital (thereby reducing the denominator), a banking entity would face both practical and fiduciary issues if it were required to withdraw capital to stay below the 3% limit. Redemption of the banking entity's investment could actually exacerbate a fund's declining value, potentially create a race to redeem and potentially push the banking entity's redemption ahead of other redeeming investors. So a banking entity should not be deemed to be in violation of the 3% de minimis limits as a result of market events outside its own control, such as a decline in value or redemptions of other investor interests. Similarly if the banking entity's interests somehow rose relative to the value of the fund for some other reason (this is for argument's sake - it's hard to imagine a situation when they would not rise in tandem), that also should not trigger a fire-sale. Similarly, it would be equitable for banking entities not to have the benefit of increasing its stake in a fund in the event subscriptions to the fund increases after the end of the seed period.

Directed Trustees
In issuing the final rule, the agencies should exclude directed trustees from the definition of the term "trustee" as used in the definition of "sponsor." Directed trustees do not manage or control funds or exercise investment discretion, but act more like custodians performing ministerial functions, such as safekeeping, settlement, accounting, administrative and other functions relating to asset control.

Carried Interest
Subsection (d)(1)(G)(iii) and (d)(4) provides that a banking entity is permitted to make de minimis investments in a hedge fund or private equity fund as long as the banking entity reduces its investment to not more than 3% of the total ownership interests in the fund after a seeding period. Carried interest is a form of incentive compensation commonly used by hedge funds and private equity funds. It is simply a participation in the fund's profits and does not generally have the corresponding rights (e.g., voting rights) of limited partners in a fund. It should be treated as incentive compensation for the purposes of the Volcker Rule whether it is held as an interest in the fund or taken as a distribution of cash or other property. If carried interest were deemed somehow to be an "ownership interest" for purposes of measuring the 3% de minimis test, by that definition, the "total ownership interest" of a fund would then exceed 100% (i.e., equity + carried interest > 100%), a nonsensical result. In other words, carried interest incentives create the rules for dividing up the pie of potential profits, they don't somehow add a whole new pie that should count towards the 3%. If there are no profits, there is no carry. To count carried interest as part of a banking entity's ownership interest in a fund would fundamentally alter the form of employee compensation, without any benefit for the safety and soundness of banking entities or the financial system generally.

Thanks Bret,

Nat

Nathaniel Hoopes

Legislative Director
Senator Scott P. Brown (R-MA)

From: "Hoopes, Nat (Scott Brown)" [redacted]

Sent: Friday, March 25, 2011 4:05:57 PM

To: [redacted]

Cc:

Subject: RE: Volcker 3% thoughts

Attachments:

Yeah - sorry about that!!!! It's pretty straightforward I hope. I just couldn't stand the thought of another formal letter from my boss to his triathlon buddy Geithner that that you guys would feel compelled to actually respond to and go through that whole process. So I added details in the email but saved you that pain!!!!!

-----Original Message-----
From: [redacted]
Sent: Friday, March 25, 2011 4:03 PM
To: [redacted] Hoopes, Nat (Scott Brown)
Subject: RE: Volcker 3% thoughts

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banking entity, as long as they are offered to those investors in compliance with SEC requirements. A bank-affiliated fund that performs very well, for instance, might be raising a new fund and catch the eye of a qualified investor - a pension fund or endowment or high net worth individual - that is not, and has not previously been, an investor or a client of the bank.

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The FSOC Study, however, strangely suggests that Super 23A could also apply to funds with which a banking entity has substantial relationships without specifying that they need to be an affiliate of the banking entity under the Bank Holding Company Act. There is no statutory basis for extending Super 23A in that way. The text is clear: it only applies to funds that are sponsored, advised, managed or organized and offered by a banking entity, or funds that are controlled by such funds (meaning effectively that the fund is a subsidiary of the fund). In fact, Senators Merkley and Levin introduced an amendment (S.A. 4101) that would have extended Super 23A in the manner the FSOC Study now suggests is still possible. That amendment was never granted a vote in the Senate. To now try to reconstitute that rejected concept would be to over-ride clear Congressional intent. Unlike possible bailouts of affiliated funds (which is addressed in the law), such a reading would also be a "solution in search of a problem."

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Employee pension funds are highly regulated: Their trustees have extensive fiduciary duties under

ERISA; they are required to invest pension assets in a manner that is in the best interest of the employees - if the best interest of the employees would be served by allocating a portion of the fund assets to investments in hedge funds or private equity funds, the trustees should be allowed to do so. Pension funds for the employees of both banking entities and non-banking entities currently invest a portion of their portfolio in hedge funds or private equity funds as a means of diversification, asset allocation and portfolio management. It is inconceivable that Congress intended for the Volcker Rule to interfere with such investment activities and to uniquely penalize employees of banking entities by doing so.

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Thanks Bret,

Nat

Nathaniel Hoopes
Legislative Director
Senator Scott P. Brown (R-MA)

From: "Hoopes, Nat (Scott Brown)" [redacted]

Sent: Thursday, March 03, 2011 5:29:08 PM

To: "[redacted]

Cc:

Subject: Volcker Implementation

Attachments:

Can we get together for 20 min on this very soon (like tomorrow or Monday)? I'll metro over there to chat at coffee shop if you want to keep it simple. Just want to let you know what I'm hearing on competing interpretations on implementation of the 3% of Tier 1 on bank sponsorship of funds and want to make sure that it all goes the right way after all the heat we've taken. This should be very simple and straightforward and I think the Fed is over-complicating it.

Nat

Nathaniel Hoopes
Legislative Director
Senator Scott P. Brown (R-MA)